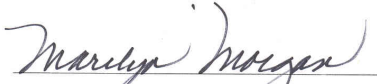




The following constitutes
the order of the court. Signed July 23, 2008


Marilyn Morgan
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re SONICBLUE INCORPORATED, a
Delaware Corporation, et al.,

Debtors.

Case No. 03-51775-MM

Chapter 11

DENNIS J. CONNOLLY, chapter 11 trustee,

Plaintiff,

Adversary No. 08-5084

vs.

PILLSBURY WINTHROP SHAW
PITTMAN LLP,
Defendant.

**MEMORANDUM DECISION ON
PILLSBURY WINTHROP SHAW
PITTMAN LLP'S MOTION TO DISMISS
COMPLAINT, OR DISMISS AND/OR
STRIKE PORTIONS OF COMPLAINT**

BACKGROUND

After an eleven month investigation, Dennis Connolly, trustee of the estates of SONICblue Incorporated and its three operating subsidiaries, filed an adversary proceeding that alleges breach of fiduciary duty, legal malpractice and failure to disclose conflicts of interest by SONICblue's bankruptcy counsel, Pillsbury Winthrop Shaw Pittman LLP. PWSP has moved, under Bankruptcy Rule 7012(b),

1 to dismiss each of the complaint's three counts for failure to state a claim upon which relief can be
2 granted. Alternatively, PWSP asks that a portion of the prayer for relief be stricken as legally
3 insufficient.

4
5 By way of background, in 1996, long before SONICblue filed for bankruptcy protection, PWSP
6 assisted SONICblue with a private placement of \$103.5 million in 5¾% convertible subordinated notes
7 ("1996 Notes"). Beginning in 2000, however, SONICblue sustained significant operating losses. To
8 offset the losses, SONICblue, with PWSP's knowledge, began to sell off stock that it owned in United
9 Microelectronics Corporation. Then, in April 2002, PWSP helped SONICblue raise additional funds
10 through a second private placement of \$75 million in 7¾% senior secured subordinated convertible
11 debentures ("2002 Notes"). Three institutional bondholders ("2002 Noteholders"), acquired the notes
12 for \$62.25 million. The infusion of capital did not work and, in October 2002, SONICblue consulted
13 PWSP for restructuring advice. SONICblue and its three operating companies filed chapter 11 petitions
14 on March 21, 2003.

15
16 The court must accept all well-pleaded allegations of the complaint as true and construe all
17 reasonable inferences from those allegations in the Trustee's favor. *Jenkins v. McKeithen*, 395 U.S.
18 411, 421, 89 S. Ct. 1843 (1969). With that principle in mind, the allegations and inferences from the
19 514 paragraphs detailed in the complaint are stated in a light favorable to the Trustee as summarized
20 below.
21

22 ALLEGATIONS OF THE COMPLAINT

23 **1. Issuance of the 2002 Notes.**

24
25 Leading up to the issuance of the 2002 Notes, SONICblue consulted PWSP for legal advice
26 regarding the financing. In the course of providing that service, PWSP did not advise SONICblue's
27

1 officers and directors that SONICblue should obtain a complete financial analysis, business plan and
2 projection of its business operation before issuing the notes. Additionally, PWSP raised no alarm bell
3 to alert the officers and directors that the 2002 Notes might be considered death spiral financing or that
4 issuance of the notes might breach fiduciary duties owed to SONICblue's creditors because SONICblue
5 was within or near the zone of insolvency.
6

7 **2. The Investment Board and Pachulski Letters.**

8 Following the issuance of the 2002 Notes, certain SONICblue creditors challenged the timing
9 and wisdom of SONICblue's decision to incur new debt. In June 2002, the State of Wisconsin
10 Investment Board wrote both to SONICblue's general counsel, David Gershon, and to PWSP, asserting
11 that the circumstances surrounding the issuance of the 2002 Notes suggested that SONICblue's board
12 of directors had failed to adequately investigate the transaction and had engaged in "apparent
13 mismanagement, fraud or other impropriety." The Investment Board questioned whether SONICblue's
14 directors exercised informed, disinterested business judgment and accused the company of engaging in
15 death-spiral financing that was detrimental to the company's equity holders. In addition to PWSP's
16 receipt of the letter, Gershon directly told PWSP that the Investment Board was contemplating a legal
17 challenge to SONICblue's issuance of the 2002 Notes.
18
19

20 Although PWSP knew that it had not advised SONICblue about death spiral financing during
21 the negotiation and issuance of the 2002 Notes, it summarily rejected the authorities cited in the
22 Investment Board's letter and concluded that the 2002 Notes did not qualify as death spiral financing.
23 Further, PWSP assumed, without investigating, that SONICblue would have dismissed any concerns
24 it might have had even if the transaction did amount to death spiral financing. As a result, PWSP denied
25 the Investment Board's allegations without consulting SONICblue's officers and directors.
26
27
28

1 Similarly, in July 2002, Richard Pachulski, counsel for some of the investors who purchased the
2 1996 Notes, raised concerns about the 2002 Notes, SONICblue's solvency and whether SONICblue's
3 board of directors had received adequate legal advice. His letter to SONICblue's Chairman, President
4 and CEO stated:
5

6 Our chief concern, therefore, is that the Company may be, or shortly become, insolvent.
7 As I hope counsel may have advised you, when a corporation is within, or in the vicinity
8 of, the zone of insolvency, the fiduciary duties owed by its directors and officers expand
9 to include not only the interests of shareholders but also those of other stakeholders, such
10 as bondholders . . . [case citations omitted].

11 Pachulski also contended that usurious terms and the secrecy with which the 2002 Notes were issued
12 indicated that SONICblue's SEC filings and public announcements did not portray an accurate picture
13 of the company's financial condition.

14 After PWSP reviewed both the Investment Board and the Pachulski letters, PWSP began to
15 prepare a memorandum for SONICblue's directors and officers to advise them about their expanded
16 fiduciary duties while SONICblue was in the zone of insolvency. On October 11, 2002, even though
17 PWSP had not completed its zone of insolvency memorandum or otherwise advised SONICblue's
18 directors and officers of any additional duties, PWSP responded to the Pachulski letter, misrepresenting
19 that SONICblue's "directors and officers are well aware of their fiduciary duties within the 'zone of
20 insolvency.'" Pachulski's follow-up letter, dated October 23, 2002, reiterated his clients' concern that
21 SONICblue's directors and officers breached their fiduciary duties by failing to obtain a complete
22 financial analysis, business plan and projection before issuing the 2002 Notes.
23

24 PWSP never alerted SONICblue that the Investment Board and Pachulski letters, at least
25 implicitly, accused PWSP of legal malpractice. As a result, PWSP did not notify SONICblue that it
26 should retain independent counsel to respond to the allegations in either the Investment Board letter or
27

1 the Pachulski letters. Further, PWSP failed to obtain SONICblue's informed consent to continue as
2 PWSP's counsel despite the potential conflicts described in the letters.

3 **3. Sales of UMC Stock.**

4
5 Between the issuance of the 2002 Notes and SONICblue's decision to seek bankruptcy
6 protection, the company continued to sell off shares of UMC stock to cover operating losses. PWSP
7 knew that the UMC stock was one of SONICblue's most valuable assets. Nevertheless, PWSP failed
8 to advise SONICblue's officers and directors that the stock sales might violate the officers' and
9 directors' fiduciary duties while in the zone of insolvency or to provide SONICblue with the legal
10 memorandum that PWSP had begun to prepare on zone of insolvency issues.

11
12 The 2002 Noteholders demanded that SONICblue cease all sales of UMC stock because the
13 company's officers and directors had failed to properly analyze UMC's business prospects before selling
14 the stock. The 2002 Noteholders contended that SONICblue, as well as its officers and directors, had
15 breached fiduciary duties owed to SONICblue's creditors while within the zone of insolvency.

16 **4. Preferential Transfers.**

17
18 On October 25, 2002, PWSP and SONICblue entered into a new retention agreement in
19 contemplation of SONICblue's bankruptcy filing. As part of the agreement, PWSP insisted on a
20 replenishing retainer provision that was designed to avoid preferential transfers by eliminating payments
21 on account of antecedent debt. Specifically, the agreement required SONICblue to prepay PWSP's fees
22 by posting an initial \$500,000 retainer and then replenishing the retainer so it never fell below \$300,000.
23 During the five month period between the date of the retention agreement and SONICblue's bankruptcy
24 filing, PWSP received \$2,118,837.41 from SONICblue.
25
26
27
28

1 In its initial Rule 2014 disclosure accompanying the firm's 2003 employment application, PWSP
2 acknowledged that it had received payments from SONICblue during the 90-day period preceding the
3 petition date. At the time of that disclosure, PWSP either knew or should have known that at least a
4 portion of the payments received prior to the petition date was attributable to antecedent debt.
5 Nevertheless, PWSP attorney, Craig Barbarosh, misrepresented, under penalty of perjury, that none of
6 the payments was on account of antecedent debt.
7

8 In Fall 2005, SONICblue's creditors began to question the accuracy of PWSP's assertion that
9 it did not receive any preference period payments from SONICblue that were on account of antecedent
10 debt. Sensing trouble, PWSP conducted an internal analysis comparing its preference period receipts,
11 the size of its retainer and the outstanding amount due for work it had performed. The analysis revealed
12 that, contrary to the intent of the retainer, there were several occasions where the retainer only exceeded
13 outstanding bills, not the full amount owed based on unpaid bills plus unbilled services rendered. In light
14 of the analysis, PWSP knew that the retainer provision in the October 25, 2002 retention agreement had
15 failed to perform as expected, that the firm might have preference exposure as great as \$1,432,851.20,
16 and that its initial and supplemental 2014 declarations had incorrectly represented that the firm had
17 received no payments on account of antecedent debt.
18

19 Following the internal analysis, PWSP further commissioned one of its attorneys to prepare a
20 detailed legal memorandum in an effort to establish either that any payments received were not on
21 account of antecedent debt or that the firm had a valid defense to preference liability. Despite PWSP's
22 hopes, the memorandum concluded that PWSP received at least some payments on account of antecedent
23 debt, that PWSP lacked any complete defense and that, if PWSP had received a preference, it held an
24 interest adverse to the estate from the inception of its employment as estate counsel.
25
26
27
28

1 In the face of PWSP's long-standing awareness of potential preference problems and its
2 confirmation of the same in early 2005, PWSP still failed to disclose its receipt of preferential payments
3 to the court or to SONICblue's creditors. To the contrary, in February 2006 and thereafter, PWSP
4 willfully and consciously misled committee counsel by continuing to assert that PWSP received no
5 preference period payments on account of antecedent debt. Specifically, PWSP prepared and sent an
6 email to committee counsel attempting to explain why the receipts should not be characterized as
7 antecedent debt even though PWSP knew that the position it was taking was not legally supportable.
8 PWSP's failure to disclose its receipt of preferential payments to its client, its creditors or to the court
9 consciously and willfully placed the firm's economic interest above those of the estates.
10

11 **5. Insurance Policy Renewals.**
12

13 In late 2002, SONICblue sought directors and officers insurance ("D&O insurance") from
14 Admiral Insurance Company and Old Republic Insurance Company (collectively the "Insurance
15 Carriers") to renew a Lloyds of London policy set to expire in December of that year. As part of the
16 process, the Insurance Carriers required applications describing all written claims or demands that
17 SONICblue or any of its officers and directors had received during the five previous years. Although
18 PWSP assisted SONICblue with preparation of the renewal applications, PWSP failed to disclose or
19 advise SONICblue to disclose the Investment Board and Pachulski letters or the 2002 Noteholders'
20 demand to cease selling UMC stock that SONICblue had received earlier that year. Based on the
21 information provided, the Insurance Carriers issued a one year renewal of the insurance policies.
22

23 Early in 2003, Gibson, Dunn & Crutcher LLP, on behalf of some of SONICblue's directors and
24 officers, demanded copies of the Investment Board and Pachulski letters from PWSP. After receiving
25 and reviewing the correspondence, Gibson Dunn notified PWSP that PWSP had failed to directly notify
26
27
28

1 the Insurance Carriers of claims in the letters and had failed to advise SONICblue to notify the Insurance
2 Carriers. Similarly, in December 2003, certain 1996 Noteholders advised PWSP that PWSP had failed
3 fulfill its obligation to independently disclose or have SONICblue disclose the Pachulski letters and the
4 2002 Noteholders' demands in the renewal applications. They further asserted that the failure to disclose
5 the claims and demands violated the claims reporting requirements in the original Lloyds' policy.
6

7 After PWSP failed to correct the nondisclosures, Gibson Dunn notified the Insurance Carriers of
8 the claims on December 15, 2003. Shortly thereafter, the Insurance Carriers sent word to SONICblue's
9 officers and directors that Insurance Carriers would discontinue all D&O insurance coverage until the
10 Insurance Carriers completed a review of SONICblue's failure to report the claims on the renewal
11 applications.
12

13 About a year later, on March 18, 2005, PWSP filed an adversary complaint against the Insurance
14 Carriers to recover insurance premiums that SONICblue paid to the Insurance Carriers during the
15 preference period preceding SONICblue's bankruptcy. Then, on April 21, 2005, some of the 1996
16 Noteholders initiated a state court breach of fiduciary duty action against SONICblue's officers and
17 directors relating to SONICblue's issuance of the 2002 Notes. In light of these new lawsuits, the
18 Insurance Carriers issued a notice of intent to rescind SONICblue's D&O policies and to deny coverage
19 for the 1996 Noteholders' complaint. As ground for the Insurance Carriers' decision, the notice asserted
20 that PWSP and SONICblue engaged in material misrepresentations by failing to disclose in the renewal
21 applications both the claims made in the Pachulski letter and the 2002 Noteholder demand that the UMC
22 stock sales were improper.
23
24

25 PWSP recognized that the insurance carriers' decision to rescind the insurance coverage could
26 have severe ramifications for PWSP and alerted the firm's general counsel of a potential claim against
27
28

1 the firm. Further influenced by the Insurance Carriers' notice of intent to rescind, PWSP also
2 recommended that SONICblue dismiss its preference litigation against the Insurance Carriers; it was
3 dismissed on November 11, 2005. Yet, PWSP never revealed to SONICblue that it had a conflict or
4 potential conflict of interest related to the legal advice it gave on the renewal applications or that
5 SONICblue should seek independent counsel to prosecute the preference action against the Insurance
6 Carriers. PWSP also failed to solicit SONICblue's informed consent to continue to represent the
7 company despite PWSP's conflict.

9 **6. Tolling Agreement.**

10 After dismissal of SONICblue's preference action against the Insurance Carriers, the Insurance
11 Carriers, through their own adversary proceeding, requested declaratory relief to establish that they had
12 no obligation to provide coverage related to the 1996 Noteholder action against SONICblue's officers
13 and directors. That prompted the officers and directors, in June 2006, to demand indemnity from
14 SONICblue both with respect to the 1996 Noteholder litigation and the Insurance Carriers' new request
15 for a declaratory judgment. At the same time, counsel for the officers and directors contacted PWSP's
16 claims attorney, John Grenfell, to request an agreement to toll the statute of limitations on any
17 malpractice or other claims that the officers and directors might have against PWSP. PWSP executed
18 the tolling agreement on August 18, 2006.

21 Recognizing its potential liability to SONICblue's officers and directors regarding both the
22 insurance renewal applications and the issuance of the 2002 Notes, PWSP transferred responsibility for
23 resolving the officers' and directors' indemnity demands to committee counsel. Nevertheless, PWSP
24 failed to inform SONICblue of the conflict and failed to obtain written consent from its client to continue
25

1 its representation. It did not even notify SONICblue that it had transferred the directors' and officers'
2 indemnity claims to committee counsel.

3 Subsequently, Grenfell prepared a summary of matters related to SONICblue that presented
4 potential claims against Pillsbury, including, among other matters, the tolling agreement. PWSP
5 consciously decided to keep the summary away from William Freeman, the PWSP attorney who signed
6 the Eighth Supplemental Rule 2014 declaration. Not surprisingly, the Eighth Supplemental declaration,
7 as executed, did not disclose the existence of the tolling agreement.
8

9 **7. Decision to Allow D&O Insurance to Lapse.**

10 Unlike the original D&O insurance policies issued by Lloyds, the renewal policies
11 provided for a new exception to the "insured v. insured" exclusion from coverage. It provided that claims
12 brought by a trustee, an examiner or similar entity (such as an official committee of unsecured creditors)
13 would not fall within the "insured v. insured" exclusions from coverage (the "Bankruptcy Exception").
14 Shortly after SONICblue filed for bankruptcy, committee counsel reviewed the renewal policies and,
15 incorrectly, concluded that claims brought by a trustee, examiner or similar entity would not fall within
16 the scope of insurance coverage. Although PWSP was aware of the Bankruptcy Exception, it failed to
17 advise the committee or SONICblue. As a result, neither SONICblue nor the committee ever investigated
18 whether there were any claims to be asserted on behalf of SONICblue. Instead, the committee filed a
19 notice with the bankruptcy court that SONICblue would not extend its D&O insurance beyond its
20 December 16, 2003 lapse date and that SONICblue would not pursue any claim against the company's
21 officers and directors.
22
23
24
25
26
27
28

- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8
- 9
- 0
- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8
- 9
- 0
- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8

2
3
4
5
6
7
8
9
0
1
2
3
4
5
6
7
8
9
0
1
2
3
4
5

5
6

7

9
0
1

2

4
5

7

9
20
21
22
23
24
25

1 decided not to proceed due to “political sensitivity.” It also recognized that it could not ask committee
2 counsel to pursue an objection because the 2002 Noteholders were members of the committee.

3 Finally, in July 2006, PWSP advised the 2002 Noteholders that SONICblue intended to object
4 to their claim. Counsel for the 2002 Noteholders responded to PWSP stating that PWSP’s 2002 opinion
5 letter constituted an agreement to indemnify the 2002 Noteholders if they were precluded from
6 recovering the full value of the 2002 Notes. He followed up with a written demand for indemnification
7 that further threatened PWSP with claims for negligence and misrepresentation related to the opinion
8 letter.
9

10 Despite PWSP’s belief that committee counsel should not handle a claims objection directed
11 against a committee member, PWSP transferred resolution of the 2002 Noteholders’ claims to committee
12 counsel. Nevertheless, the 2002 Noteholders’ threats remained an impediment to PWSP’s representation
13 of SONICblue. PWSP waited six months to disclose this conflict to SONICblue, SONICblue’s creditors
14 or the court. Further, PWSP never sought or obtained SONICblue’s informed consent to continue
15 representation despite the conflict.
16

17 **9. VIA Settlement.**
18

19 In 2000, SONICblue transferred its graphics chip business to a joint venture that it formed with
20 VIA Technologies, Inc. SONICblue gave the joint venture all rights under a 1998 patent cross-license
21 agreement between SONICblue and Intel Corporation. Shortly after SONICblue filed its bankruptcy
22 petition, Intel filed a motion for relief from stay to terminate the patent cross-license agreement. Because
23 the cross-license was essential to the joint venture, VIA and the joint venture each filed a \$70 million
24 claim against SONICblue based on any loss of the joint venture’s rights under the cross-license.
25 SONICblue objected to the claims and sought affirmative relief against VIA and the joint venture.
26
27
28

1 On September 15, 2005, the attorneys for SONICblue, VIA, and the joint venture agreed in
2 principle to a settlement that would provide VIA and the joint venture with one \$12.5 million allowed
3 claim. Even though PWSP owed fiduciary duties to the SONICblue and none to the 2002 Noteholders,
4 PWSP took the initiative to inform the 2002 Noteholders that the VIA allowed claim might rank senior
5 in right of payment to the 2002 Noteholders' claims. After learning of that possibility, the 2002
6 Noteholders insisted that they would only consent to the settlement if a term was added to expressly
7 provide that the VIA allowed claim would not rank senior in payment priority to the 2002 Noteholders'
8 claims.

10 Both PWSP and special counsel for SONICblue acceded to the 2002 Noteholders' demand.
11 However, the 2002 Noteholders did not offer and PWSP, despite its fiduciary obligations, did not request
12 any consideration from the 2002 Noteholders in return. Then, in May 2006, PWSP reconsidered the
13 language used to waive VIA's seniority rights and concluded that, as originally drafted, it might not
14 adequately protect the 2002 Noteholders. PWSP, on its own, proposed modified language to better
15 protect the 2002 Noteholders. Again, PWSP failed to request any consideration for the estate in return.
16 Although VIA could have obtained the same economic recovery from a smaller claim entitled to priority
17 versus a larger claim without priority, PWSP failed to advise SONICblue concerning the ramifications
18 of choosing one option over the other.

21 In October 2006, about one month after the 2002 Noteholders's indemnity demands related to
22 PWSP's opinion letter, PWSP filed a motion to approve the VIA settlement. Although PWSP knew that
23 the waiver of VIA's priority benefitted the 2002 Noteholders, PWSP did not disclose the waiver as part
24 of the motion to approve the settlement. It also did not disclose that the 2002 Noteholders refused to
25 consent to the settlement unless the waiver of VIA's priority was incorporated.

1 **10. Failure to File Tax Returns.**

2 In August 2003, SONICblue sought advice from PWSP about filing its 2002 tax returns. Despite
3 the request for advice, PWSP failed to inform SONICblue that it needed to file timely returns. After the
4 committee recognized that SONICblue had not filed timely returns, the committee asked its own
5 accounting and litigation consultants to bid on preparing the company's 2002 and 2003 tax returns.
6 SONICblue turned down the committee's consultant and retained its own tax preparation firm.
7 SONICblue still failed to file the returns. Because PWSP failed to adequately advise SONICblue about
8 its tax filing obligations, SONICblue was precluded from selling its "tax attributes" to a third party for
9 \$100,000.
10

11 **11. Substantive Consolidation.**

12 In late 2006, PWSP drafted a proposed plan of reorganization that SONICblue filed jointly with
13 the committee. The plan provided for substantive consolidation of the four debtor estates but no
14 consolidation of SONICblue's other non-debtor subsidiaries. PWSP did not seek substantive
15 consolidation of the non-debtor entities because it would negatively affect contingency fees that PWSP
16 might receive from pursuing preference actions on SONICblue's behalf.
17
18

19 **12. Failure to Maintain Security Interests and Preserve Inter-Company Claims.**

20 Prior to bankruptcy, SONICblue's three operating companies, Diamond Multimedia Systems,
21 Inc., ReplayTV, Inc. and Sensory Science Corporation maintained operations by using SONICblue
22 employees and other assets. At times, SONICblue paid the expenses of the operating companies without
23 reimbursement. Although PWSP was aware of these inter-company debts, it failed to advise SONICblue
24 to file proofs of claims against the estates of the operating companies.
25
26
27
28

1 Further, in championing a plan that provided for substantive consolidation of SONICblue and its
2 three operating companies, PWSP relied on SONICblue's security interests against the assets of the
3 operating companies. However, PWSP failed to advise SONICblue to file continuation statements to
4 preserve those security interests.

7 DISCUSSION

8 **I. The First Claim for Relief Adequately States a Claim Arising Out of PWSP's Failure to** 9 **Satisfy its Rule 2014 Disclosure Obligations.**

10 The Trustee's first claim for relief alleges that PWSP willfully and consciously concealed a wide
11 variety of connections and conflicts that should have been disclosed pursuant to Bankruptcy Rule 2014.
12 PWSP asserts that this claim for relief must be dismissed because there is no private right of action for
13 damages resulting from the failure to make required Rule 2014 disclosures. Although the complaint is
14 couched in terms of "damages," the Trustee states that his first claim for relief seeks sanctions for bad
15 faith conduct based on PWSP's deliberate effort to advance its own economic interest in representing
16 SONICblue by willfully concealing the firm's conflicts of interest.

18 PWSP misapprehends the function of pleadings in federal practice. As the Ninth Circuit has
19 recognized, notice pleading only requires a plaintiff to allege *claims for relief*, not causes of action,
20 statutes or legal theories. *Alvarez v. Hill*, 518 F.3d 1152, 1157 (9th Cir. 2008). It makes no difference
21 that the first claim for relief does not specifically refer to sanctions or identify Bankruptcy Code §§ 105
22 and 327 as the basis for recovery. *Id.* at 1157-58 (plaintiff stated claim for statutory violation even though
23 he never cited to the statute). Notice pleading anticipates that subsequent proceedings will refine the
24 disputed facts and issues, including the legal theories. *Id.*

1 The real question is not whether the Trustee has a private right of action for damages, but rather
2 whether the Trustee can properly recover sanctions in the context of this adversary proceeding. While
3 sanctions are more typically requested by way of motion, courts have entertained such requests within
4 adversary proceedings, even where, as here, there may be no private right of action for damages. *See,*
5 *e.g., Knupfer v. Lindblade (In re Dyer)*, 322 F.3d 1178 (9th Cir. 2003)(contempt sanctions awarded for
6 willful violation of the automatic stay even though chapter 7 trustee had no private right of action for
7 damages under Bankruptcy Code § 362(h)); *Gray v. Assali (In re McGrath)*, 2008 WL 859152 (E.D. Cal.
8 Mar. 31, 2008); *Mini v. State of Calif., Bd. of Equalization (In re Mini)*, 2007 WL 2223820 (N. C. Cal.
9 Jul. 30, 2007).

11 A court's power to issue sanctions arises from a variety of authority, including Rule 9011, the
12 court's contempt powers and its inherent powers. *Dyer*, 322 F.3d at 1189-90 ; *Caldwell v. Unified*
13 *Capital Corp. (In re Rainbow Magazine)*, 77 F.3d 278, 284-85 (9th Cir. 1996); *In re Count Liberty, LLC*,
14 370 B.R. 259, 271 (C.D. Cal. 2007). Here, the Trustee's claim for relief is premised on the bankruptcy
15 court's inherent powers, which permit an award of sanctions where a party has acted in bad faith,
16 vexatiously, wantonly or for oppressive reasons. *Chambers v. NASCO, Inc.*, 501 U.S. 32, 45-46, 111 S.
17 Ct. 2123 (1991). It allows the court "to deter and provide compensation for a broad range of improper
18 litigation tactics." *Dyer*, 322 F.3d at 1196. *See also Rainbow*, 77 F.3d at 284.

21 To successfully obtain sanctions under the court's inherent authority, the Trustee will have to
22 establish that PWSP engaged in willful misconduct or other bad faith acts that rise above mere negligence
23 or recklessness. However, the Trustee's complaint sets forth a laundry list of willful nondisclosures,
24 which if proven, may be sanctionable. PWSP's assertion that § 328(c) of the Bankruptcy Code provides
25 the sole remedy for failure to satisfy the disclosure requirements of Rule 2014 is without merit. The
26

1 court's inherent power to sanction bad faith conduct arises from a separate and distinct source of
2 authority and is not displaced or limited by other remedies that may be available in other federal statutes
3 or rules. *Chambers*, 501 U.S. at 50-51, 111 S. Ct. 2123; *Daggett v. Cardinale (In re DeVille)*, 280 B.R.
4 483, 495 (9th Cir. B.A.P. 2002). Of course, the showing required for an award of sanctions is entirely
5 different than the simple nondisclosures needed to disallow fees under § 328(c). I am also not swayed
6 by PWSP's fear that sanctions opens the door to an award that has no relation to any damage that the
7 estate may have suffered. Awards under the court's inherent sanction authority are limited to that which
8 is appropriate and necessary to enforce the Bankruptcy Code. As the Ninth Circuit has recognized, in
9 applying a court's inherent power to sanction, only compensatory, not punitive, damage awards are
10 appropriate. *Dyer*, 322 F.3d at 1197.

11
12
13
14 **II. Plaintiff's Second and Third Claims for Relief Adequately Allege Damages Proximally**
15 **Caused by the Alleged Breaches of Fiduciary Duty and Legal Malpractice.**

16 To avoid dismissal, a complaint need only contain "enough facts to state a claim to relief that is
17 plausible on its face. *Bell Atlantic Corp. v. Twombly*, ___ U.S. ___, 127 S. Ct. 1555, 174 (2007). In
18 other words, the factual allegations "must be enough to raise a right to relief above the speculative level,
19 on the assumption that all the allegations in the complaint are true (even if doubtful in fact)." *Id.* at 1665.
20 Something more than "labels, conclusions or a formulaic recitation of the elements of a cause of action"
21 is required. *Id.* This standard is a relatively recent shift away from the Court's long familiar rule that
22 a complaint should not be dismissed unless "it appears beyond doubt that the plaintiff can prove no set
23 of facts in support of his claim which would entitle him to relief." *See Conley v. Gibson*, 355 U.S. 414,
24 78 S. Ct. 99 (1957). There is little doubt that the second and third claims for relief, which respectively
25 allege breach of fiduciary duty and legal malpractice, would survive a motion to dismiss under the *Conley*
26
27

1 formulation. *See, e.g., The Plan Committee v. Price Waterhouse Coopers, LLP*, 335 B.R. 234 (D.D.C.
2 2005)(pre-*Twombly* complaint adequately alleged causation and damages for legal malpractice).
3 However, an issue remains as to whether the allegations of causation and damage are adequate in light
4 of the retirement of the *Conley* standard.

5
6 As the Second and the Seventh Circuit have already recognized, the courts must be careful not
7 to overread the *Twombly* decision. *See Tamayo v. Blagojevich*, 526 F.3d 1074, 1982-83 (7th Cir. 2008);
8 *Iqbal v. Hasty*, 490 F.3d 143, 157-58 (2d Cir. 2007). These circuits have drawn on the conflicting signals
9 within the Supreme Court’s opinion to conclude that *Twombly* does not universally amplify the pleading
10 requirements set out in Fed. R. Civ. P. 8(a). Rather, the “plausibility” standard enunciated by the court
11 is flexible. At most, it requires additional factual allegations in certain contexts, but only as necessary
12 to show that the plaintiff’s right to relief is plausible. *Tamayo*, 526 F.3d at 1083, *Iqbal*, 490 F.3d at 157-
13 58.

14
15 I find the reasoning of *Tamayo* and *Iqbal* to be persuasive. Despite the Supreme Court’s adoption
16 of the “plausibility” standard, *Twombly* did not entirely overrule *Conley*. To the contrary, at points, the
17 decision in *Twombly* cited *Conley* with favor, reiterating that a complaint’s purpose is properly limited
18 to providing the defendant with fair notice of what the claim is and the grounds upon which it rests. *Id.*
19 at ___, 127 S. Ct. at 1964, *quoting, Conley v. Gibson*, 355 U.S. at 47. While a plaintiff may not rely on
20 “mere labels, conclusions or a formulaic recitation of the elements of a cause of action,” *Twombly*, 127
21 S. Ct. at 1965, ultimately all that Fed. R. Civ. P. 8 (a)(2) requires is a short and plain statement showing
22 that the plaintiff is entitled to relief. Detailed factual allegations remain unnecessary. *Twombly*, 127 S.
23 Ct. at 1964. Two examples are illustrative. The Court in *Twombly* explicitly noted the sufficiency of
24 Form 9 of the Federal Civil Rules, Complaint for Negligence. That standard form complaint alleges that
25
26
27
28

1 a defendant “negligently drove a motor vehicle against plaintiff who was then crossing [an identified]
2 highway” without any supporting facts describing how the defendant was negligent. *Id.* at 1970, n.10.
3 Also, just two weeks after the decision in *Twombly*, the Supreme Court ruled that a pro se prisoner did
4 not need to allege specific facts to support his claim of cruel and unusual punishment. It was enough that
5 the prisoner had alleged that he had Hepatitis C, that prison officials withheld treatment and that his life
6 was in danger as a result. *See Erickson v. Pardus*, __ U.S. __, 127 S. Ct. 2197 (2007).

8 The conclusion that additional factual allegations are only required where necessary to establish
9 the plausibility of the plaintiff’s claims is also in accord with the Ninth Circuit’s treatment of *Twombly*.
10 Although the Ninth Circuit has not yet engaged in an in-depth analysis of *Twombly*, its post-*Twombly*
11 decisions have consistently reiterated that under Fed. R. Civ. P. 8 the federal courts continue to apply a
12 notice-pleading standard, that a complaint need only contain sufficient facts to support a cognizable legal
13 theory, and that pleadings must be construed liberally to achieve “substantial justice.” *See, e.g.,*
14 *Mendiondo v. Centinela Hospital Medical Center*, 521 F.3d 1097, 1103-04 (9th Cir. 2008); *Alvarez v.*
15 *Hill*, 518 F.3d 1152, 1157 (9th Cir. 2008); *Skaff v. Meridien North America Beverly Hills, LLC*, 506 F.3d
16 832, 839-42 (9th Cir. 2007). The only circumstance under which the Ninth Circuit has required
17 heightened pleading, like *Twombly*, is the antitrust context, like *Twombly*. *See e.g., Rick-Mik Enterprises,*
18 *Inc. v. Equilon Enterprises, LLC*, __F.3d__, 2008 WL 2697793, at *5 (9th Cir. July 11, 2008)(for
19 purposes of pleading in antitrust cases, the Supreme Court abrogated the usual notice pleading rules);
20 *Kendall v. Visa U.S.A., Inc.*, 518 F. 3d 1042, 1047 n.5 (9th Cir. 2008)(same).

21 Under the principles explained above, the second and third claims for relief survive PWSP’s
22 motion to dismiss. Far from relying on “mere labels, conclusions or a formulaic recitation of the
23 elements” of his causes of action,” the Trustee has alleged detailed facts showing that PWSP may have
24
25
26
27
28

1 committed errors both in judgment and action that breached its fiduciary duties. Additionally, the path
2 PWSP chose to follow, if proven, may have fallen below the standard of ordinary care. Although the
3 Trustee's ultimate allegations of causation and damage are succinctly stated in a conclusory fashion, the
4 myriad of facts alleged in his complaint demonstrate a plausible basis for inferring that PWSP's wrongful
5 conduct harmed SONICblue. A complaint need only contain direct or inferential allegations regarding
6 all material elements of a claim. *Twombly*, 127 S. Ct. at 1965. *See also Iqbal*, 490 F.3d at 170
7 (conclusory allegation of knowledge for supervisory liability was adequate where, under the facts, it was
8 at least plausible that a warden would know of mistreatment inflicted by those under his command).
9 Here, specific allegations of the type and amount of harm is unnecessary.

10
11 Even after *Twombly*, the issue at the pleading stage is not whether the Trustee will ultimately
12 prevail, but whether he has given sufficient notice of his claims to be entitled to proceed beyond the
13 pleading stage. *De La Cruz v. Tormey*, 582 F.2d 45, 48 (9th Cir. 1978), *cert. denied*, 441 U.S. 965 (1979).
14 As long as notice of a claim and the grounds upon which it rests is given in satisfaction of Fed. R. Civ.
15 P. 8, concerns about specificity in pleading are better addressed through the array of discovery devices
16 available to PWSP. *Meridien*, 506 F.2d at 842. Whether the Trustee can prove causation and damages
17 may be better suited for summary judgment.
18
19
20

21 **III. The Trustee's Request to Recover his Attorneys' Fees Incurred in Prosecuting this**
22 **Adversary Proceeding Is Limited, But Not Stricken.**

23 PWSP urges that even if the complaint is not dismissed outright, the Trustee's request to recover
24 "attorneys' fees incurred in bringing this action" should be denied as improper under the American Rule.
25 PWSP does not object, at this time, to the recovery of fees incurred in the course of the Trustee's
26 investigation of the bankruptcy cases and the estates' claims. The Trustee contends that he is entitled
27
28

1 to recover his fees associated with this adversary proceedings as a natural and foreseeable consequence
2 of the alleged breaches of fiduciary duty and legal malpractice.

3 Under the American Rule, litigants bear their own attorneys' fees. A prevailing litigant is
4 ordinarily not entitled to attorneys' fees from the non-prevailing party. *Travelers Casualty & Surety Co.*
5 *of America v. Pacific Gas & Electric Co.*, __ U.S. ___, 127 S. Ct. 1199, 1203 (2007); *Alyeska Pipeline*
6 *Service Co. v. Wilderness Society*, 421 U.S. 240, 247, 95 S. Ct. 1612, 1616 (1975). Nevertheless, this
7 rule can be overcome by statute or an enforceable contract provision allocating attorneys' fees.
8 *Travelers*, 127 S. Ct. at 1203. The Trustee's attempt to circumvent the American Rule because the fees
9 associated with this litigation are foreseeable damages attributable to PWSP's tortious conduct is not
10 persuasive. That argument could be made in virtually any litigation context and, if fees were allowable
11 on that basis, it would eviscerate the American Rule. Moreover, the fees requested are not those
12 associated with additional third-party litigation that only became necessary due to PWSP's alleged
13 tortious conduct. As a result, the fees do not constitute an item of damage based on the "third party
14 exception" to the American Rule and will not be allowable item of damage with respect to the second
15 and third claims for relief.

16 In the context of civil sanctions, however, attorneys' fees and other costs of pursuing the sanctions
17 award are an appropriate item of compensatory damages or sanctions. *Dyer*, 322 F.3d at 1193. The
18 Trustee's complaint uses an all-inclusive prayer for relief that sets forth various items of recovery without
19 connecting each item to a specific claim for relief. Because attorneys' fees might be appropriate with
20 respect to the first claim for relief, the prayer will not be stricken from the complaint.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

CONCLUSION

Based on the foregoing, the court concludes that PWSP's Motion to Dismiss Complaint, or Dismiss and/or Strike Portions of the Complaint is denied. PWSP is directed to file its Answer to the complaint on or before August 4, 2008.

Good cause appearing, IT IS SO ORDERED.

**** END OF ORDER ****

2
3
4 **UNITED STATES BANKRUPTCY COURT**
5 **FOR THE NORTHERN DISTRICT OF CALIFORNIA**
6 **SERVICE LIST**
7

8 James L. Lopes Grant T. Stein
9 Steven E. Schon ALSTON & BIRD LLP
10 Bernard A. Burk 1201 West Peachtree Street
11 Gary M. Kaplan Atlanta, Georgia 30309
12 HOWARD RICE NEMEROVSKI CANADY FALK &
13 RUBIN
14 Three Embarcadero Center, 7th Floor
15 San Francisco, CA 94111-4024
16

17 Cecily A. Dumas
18 FRIEDMAN DUMAS & SPRINGWATER LLP
19 150 Spear Street, Suite 1600
20 San Francisco, CA 94105
21
22
23
24
25
26
27